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SUBJECT: KAZAKHSTAN: REGIONAL ELECTRICITY MARKET MUST OVERCOME
POLITICAL, TECHNICAL CHALLENGES

REF: 08 ASTANA 2086

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¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: On February 5, Energy Officer accompanied USAID Senior Energy Policy Specialist Michael Trainor to meetings with major players in Kazakhstan's power sector to solicit feedback on USAID's new Regional Energy Markets Assistance Program (REMAP-II), expected to begin in March (see septel.) Kazakhstani industry representatives thanked USAID for assistance provided under the first REMAP project and expressed general support for the new project, but expressed skepticism about the near-term prospects for a regional electricity market encompassing all five Central Asia Republics and linking Afghanistan's newly-constructed North-East Power System with Central Asian high-voltage networks and generators. Instead, it was suggested that early successes are more likely with a sub-set of these countries, including Kazakhstan, Kyrgyzstan, and Tajikistan in the first instance. Several Kazakhstani commentators cited Uzbekistan's politics and past behavior, its geography and the location of critical segments of the region's high-voltage networks, and the nexus between water-resources management and hydroelectric power as major complicating factors. Discussions confirmed that reconciling the different laws, authorities, institutions, infrastructure, and tariffs of the six countries involved will be arduous work.

¶3. (SBU) SUMMARY CONTINUED: Kazakhstan's own wholesale power tariff structure is expected to change in the near future, once a Prime Ministerial decree is published to implement the new Law on Electricity, which took effect January 1. The decree will establish a seven-year price ceiling for power prices charged by generators, with tariffs varying according to the type of power generation. The chairman of the Agency for the Regulation of Natural Monopolies (ARNM) said the purpose of the decree was to attract foreign investment by guaranteeing a stable, long-term price for power companies. This is in contrast to what Energy Officer learned during a meeting on January 15 with AES, the largest Western

investor in Kazakhstan's power sector. AES said they anticipated that the government's fixed prices would be below market rates and would discourage future investment in infrastructure. END SUMMARY.

A BEAR MARKET

14. (SBU) Senior managers from the Kazakhstan Electricity Grid Operating Company (KEGOC) were skeptical of USAID's proposal to establish a regional electricity market encompassing Central Asia and Afghanistan. KEGOC Vice President Vladimir Ossochenko said the physical infrastructure of the countries in the region was at vastly different levels of development and KEGOC would not invest its own resources to modernize infrastructure in Kyrgyzstan or Tajikistan. "If we did that," he said, "we would be left with nothing." Ossochenko said that KEGOC will invest funds from a World Bank loan to upgrade and modernize Kazakhstan's own power transmission network and upgrade the power grid linking northern Kazakhstan and southern Russia.

15. (SBU) Ossochenko also suggested that it would take a decade or more to reconcile the different, often contradictory, laws of the prospective participant countries to build the necessary legal framework for a regional power market. He illustrated his point by saying that -- thanks in part to the first REMAP project -- the Kyrgyz National Electricity System was prepared to trade power via Kazakhstan's electricity market operator, KOREM, but was unable to do so because customs regulations in both countries do not accommodate exchanges brokered on the KOREM trading platform. (NOTE: Power is exchanged between Kazakhstan and Kyrgyzstan, but under separate bi-lateral contracts negotiated outside of the KOREM market framework. END NOTE)

LITTLE INTEREST IN AFGHANISTAN

16. (SBU) When asked about Afghanistan, Ossochenko simply said,

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"That's your initiative. That's in your interest, not ours." He said that Afghanistan lacks basic power infrastructure and KEGOC lacks the means to upgrade Afghanistan's grid. Ossochenko also noted that the Central Asian republics have enough difficulty generating and distributing sufficient power for domestic use and would be hard-pressed to export electricity to Afghanistan. "If Uzbekistan already cuts power to Tajikistan, which it is obliged to deliver, how can they send electricity to Afghanistan?" he asked. Ossochenko did, however, support the idea of regional training and knowledge-sharing activities with counterparts from Afghanistan.

DEBATE OVER CENTRAL AUTHORITY

17. (SBU) Despite doubts about the development of a regional market, KEGOC's Ossochenko supported USAID's proposal to upgrade the capacity of the Coordination Dispatch Center (CDC), headquartered in Tashkent and jointly-owned by the transmission system operators of Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. CDC would provide centralized high-voltage network monitoring and management services for the Central Asian electricity market. KEGOC claims it needs a stronger CDC with modern equipment to ensure the rational development of the marketplace. "Without it, we can do nothing on a regional level," Ossochenko said. According to him, CDC's communications equipment was made in the 1950s and is in dire need of replacement. (NOTE: Under the three-year, \$15 million REMAP-II project, USAID would provide a grant of up to \$1 million to CDC. END NOTE).

18. (SBU) Unlike KEGOC, the operator of Kazakhstan's electricity market, known by its Russian acronym KOREM, does not support the modernization of the Coordination Dispatch Center. KOREM's Chairman Suinshilik Tiyyessov said it would be "incorrect" and "harmful" to provide funding or assistance to the CDC. He correctly observed that CDC has no formal legal basis for interacting with the five Central Asian countries and no legal authority to issue compulsory instructions to national system operators, or to apply sanctions for non-compliance.

OVERCOMING MISTRUST OF UZBEKISTAN

¶9. (SBU) Tiyyessov noted that the CDC is based in Tashkent and called it a political instrument of Uzbekistan. "The CDC is good for the Uzbeks," he said, "because they can use it to manipulate other countries." Tiyyessov then spent several minutes explaining why Uzbekistan should not be trusted to host the CDC, arguing that Uzbekistan would most likely manipulate data reporting and grid management in favor of Uzbekenergo and at the expense of other countries' system operators. The only way to partner with Uzbekistan, he said, is to enforce contracts strictly, with financial penalties for any and all violations. According to Tiyyessov, "If you try to be nice to them and negotiate, they simply take it as a sign of weakness." (NOTE: Other senior officials, including Nesipkul Bertysbayev, Director of the Electricity Department at the Ministry of Energy and Mineral Resources, echoed Tiyyessov's comments about Uzbekistan. Bertysbayev, for example, said the CDC is "firmly under the control of the Uzbeks." END NOTE.)

¶10. (SBU) Like KEGOC's Ossochenko, KOREM Chairman Tiyyessov had doubts about the near-term prospects for a regional electricity market involving all the Central Asian republics. Tiyyessov suggested USAID first establish a regional market connecting Kazakhstan, Kyrgyzstan, Tajikistan, and Turkmenistan, which would ultimately force Uzbekistan to "play by the rules." It was unclear, however, whether that would be technically feasible immediately, since the region's power grids do not neatly conform to its national borders, and key segments of the Central Asian grid traverse Uzbekistan's territory. (NOTE: Kyrgyzstan and Tajikistan have embarked on the construction of 500kV lines connecting the two countries to the Kazakhstan grid directly, bypassing Uzbekistan. Completion, however, is still several years away. END NOTE.)

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GOVERNMENT PREPARED TO FIX ELECTRICITY PRICES

¶11. (SBU) As previously reported (reftel), Prime Minister Masimov is prepared to introduce a new decree that will set wholesale ceiling prices for electrical power for the next seven years. Power industry representatives are strongly opposed to fixed prices set by the government, although Nurlan Aldabergenov, Chairman of the Agency for the Regulation of Natural Monopolies (ARNM), defended the decree, saying it would increase investment. KOREM's Tiyyessov noted that since the decree was first drafted in October, the global financial crisis has caused major power consumers to reduce demand for electricity, which has moved the country from a power deficit to a power surplus. Tiyyessov therefore expects prices to fall on their own accord and sees little value in a government decree setting a price ceiling.

¶12. (SBU) Tiyyessov said the government is now discussing tariffs for various categories of power-generating companies, with consideration of such factors as location, fuel type, plant technology, and efficiency in determining into which category each plant will fall. The ceiling price for each category will be established at the level of the highest recorded output price of power produced and sold by generators in that category in 2008. According to Tiyyessov, the Prime Ministerial decree setting the new tariff schedule is expected to be published in May or June. (NOTE: Tiyyessov served on the parliamentary working group that drafted the Law on Electricity and successfully lobbied to include a provision allowing up to 10 percent of all electricity generated in Kazakhstan, or approximately four billion kilowatt hours, to be sold via KOREM's trading platform at a free market price, rather than the government's fixed price. END NOTE.)

AES SAYS FIXED PRICES POSE A PROBLEM

¶13. (SBU) On January 15, Doug Herron, Head of the Representative Office of AES Silk Road, Inc. in Almaty, told Energy Officer that the government's proposal to fix electricity tariffs would have a negative impact on the entire industry. He said the final rates remain under discussion and added that it was unclear whether companies could charge different rates for different customers (i.e., industrial and residential). Herron also said that coal

prices comprise 65 percent of the price of electricity, so unless the government also fixes the price of coal, power companies will be squeezed by rising input costs and restricted retail prices. (NOTE: A government working group is now considering whether to regulate coal prices as well, despite the objections of the mining industry. END NOTE.)

ANTI-MONOPOLY AGENCY UNAPOLOGETIC

¶14. (SBU) Anatoliy Shkarupa, Director of ARNM's Electricity Department, justified the draft decree as a means to attract much-needed investment into the power sector. He said that because the government has not actively regulated the electricity market for the last ten years, there have been no new investments in power generation. When reminded about the millions of dollars AES has invested in Kazakhstan's power sector, Shkarupa became defensive and said that when AES first arrived in Kazakhstan, five of the eight power blocks at Ekibastuz GRES-1 were in use. "Now, ten years later, still only five of the eight blocks are producing electricity," he said. Shkarupa claimed that AES used spare parts from other blocks to keep a maximum of five functional. He said AES has covered operational expenses, but did not make any major capital investments at the power plant in Ekibastuz, or at AES's other plants in Ust-Kamengorsk and Shulbinsk.

¶15. (SBU) Shkarupa's deputy, Khalila Kokozova, said the new Prime Ministerial decree would be a "temporary measure" and that companies planning to make capital investments could apply to the government for an "individual tariff" that would be higher than that set by the decree. Kokozova also said that power plants fueled by renewable sources of energy would constitute a distinct group of enterprises

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and would likely be granted higher, "feed-in" tariffs.

¶16. (SBU) ARNM Chairman Aldabergenov was unapologetic about the draft decree. He denied that ARNM was trying to regulate market prices, saying his agency's role was to promote capital investment, monitor investment commitments, and ensure stable, long-term market development. He confirmed, however, that ARNM would review prices annually to ensure compliance with the new decree and enable companies to petition for changes to the tariff schedule. Aldabergenov welcomed expert advice from USAID on the methodology and mechanics of power tariff regulation, and in particular requested assistance in developing options to provide tariff-based assistance to low-income households and stimulate energy conservation.

¶17. (SBU) Samruk-Kazyna National Welfare Fund representatives engaged in management of state-owned assets in the power sector exhibited strong interest in U.S. assistance to Kazakhstan's power sector. They requested that REMAP-II provide support in assessing policy options that might stimulate investment in new generation. They also asked whether the U.S. Government, under REMAP-II or otherwise, could provide direct assistance in enticing U.S. investors to explore opportunities for new plant construction in Kazakhstan. Energy Officer emphasized the importance of minimizing investors' perceptions of risk, to which USAID Senior Energy Policy Specialist offered that a sound policy and legal/regulatory framework is prerequisite for such. USAID explained that REMAP-II will contribute in this regard, and might also be in a position to assist with the conceptualization, announcement, and management of specific generation investment projects.

¶18. (SBU) COMMENT: Widespread, nearly universal criticism of Uzbekistan by key players in Kazakhstan's power sector suggests that a regional electricity market that includes Uzbekistan is unlikely to emerge in the near term. U.S. programs and policies in support of a regional market will be more effective if they focus initially on Kazakhstan, Kyrgyzstan, and Tajikistan, which have demonstrated greater willingness to cooperate on electricity issues. Furthermore, based on conversations with our interlocutors, the republics of Central Asia have yet to embrace Afghanistan as an integral part of the region. Afghanistan is widely viewed as an "American problem," not as a regional partner or potential market player. Finally, the global financial and economic crisis has hit

the region hard, forcing countries to look inward and prioritize domestic development over regional integration. In Kazakhstan, for example, the government is focused on stemming rising unemployment, maintaining the stability of the tenge, securing the solvency of the banking sector, and meeting the basic needs of the population for affordable food, housing, and energy. Kazakhstan is therefore unlikely to invest much time, money, or political capital in the near future to overcome the many obstacles to a fully integrated, regional electricity market. END COMMENT.

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